

**USAID/CAUCASUS AZERBAIJAN ENERGY SECTOR
ASSESSMENT MISSION**

MISSION REPORT

MARCH 24-29, 2002

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SUMMARY

A USAID/Caucasus mission led by Herbert Emmrich, Senior Energy Advisor USAID/Caucasus and Dean White, PA Consulting, Inc. visited Azerbaijan from March 24 - 29, 2002.¹ The objective of the mission was to gauge the current situation in the Azerbaijani energy sector with regard to progress on institutional and economic reform, commercialization and private sector participation and other related issues. The mission also assessed the status of other bilateral donor and International Financial Institution's (IFI) activities and the Government of Azerbaijan's (GOAZ) desire and need for USAID assistance.

The principal conclusions drawn from the meetings include:

- Azerbaijan has made substantial progress towards reform in the recent twelve months. The IFIs and Azerbaijani counterparts are in agreement that there are many areas in which USAID energy sector technical assistance would be useful.
- The recent (25 March) Presidential Decree on energy sector reform policy should be reviewed urgently to assess whether a short-term advisory group should be deployed to assist the Government of Azerbaijan in carrying out the elements of the decree tied to World Bank and IMF conditions.
- After review of the March 25 Presidential Decree, the World Bank, and TACIS TA programs, a further, larger scale and scope mission should return to Azerbaijan and re-examine the self-reported needs and assess further unidentified needs to develop a comprehensive and coherent energy sector assistance program proposal. This proposal should include a review of the World Bank SAC conditions and identify the technical assistance "gaps" and programs needed for the energy sector and GOAZ to meet these conditions.

The remainder of this report provides:

- A brief factual background relevant to the Azerbaijani energy sector;
- An overview of key IFI and donor activities in the energy sector;
- A summary of areas of assistance identified by the Azeris themselves, and recommended actions;
- In and Out-briefing meetings notes with Ambassador Wilson

Attachment 1 to this report lists the principal counterparts met during this mission.

Attachment 2 provides summaries of discussions held at the various meetings.

Attachment 3 March 25, 2002 Presidential Decree.

Attachment 4 provides the Terms of Reference (TOR) for the World Bank's technical assistance (TA) program for Azerbaijan.

¹ The full mission team included Herbert Emmrich, Senior Energy Advisor and Eka Aladashvili, Project Development and Legal Specialist (USAID/Caucasus); Dean White, Kirby Owen, V. Valiyev and Levan Mtchedlishvili (PA Consulting).

BACKGROUND

Following separation from the Soviet Union, the Azerbaijani energy industry was organized around three dominant State-owned operating companies: Azerenergy, responsible for the electricity sector; Azerigas, responsible for the onshore and domestic natural gas sector, and the State Oil Company of the Azerbaijan Republic (SOCAR), responsible for both onshore and offshore oil and gas production, as well as, oil (and oil products) and gas imports and exports.

Unlike most other post-Soviet countries, Azerbaijan relatively quickly eliminated any vestiges of a government Ministry of Fuel and Energy, relying instead on the principal energy sector operating companies to fulfill roles in both sector development policy and operations. Tariffs for domestic energy resources were socially motivated and governed by the collective approval of the Ministry of Economy, the Anti-Monopoly Commission and the Ministry of Finance.

Throughout the 1990s, the development of offshore oil and gas resources proceeded at a reasonable pace through the use of Production Sharing Agreements (PSA) (essentially individual special-purpose laws governing the terms of exploration and production lease agreements) negotiated by SOCAR with international petroleum companies. The PSA approach facilitated the introduction of private sector finance and operating capabilities (SOCAR is generally not the operator of the PSAs) into the upstream petroleum sector. This led to some notable successes in the petroleum exploration and production area. First, the creation of the Azerbaijan International Oil Consortium (AIOC), made up of international petroleum companies and SOCAR, led to increased oil exploration and production. This was followed by the building and successful operation of the Baku-Supsa 115,000 barrel per day crude oil pipeline in 1999. This Early Oil Pipeline success was followed by the signing of international agreements to build the Baku-Tbilisi-Ceyhan 900,000 barrel per day crude oil export pipeline. Later, the discovery of the Shah Deniz gas field laid the foundation for the proposed South Caucasus Gas Pipeline from Baku to Erzurum Turkey via Georgia. Although highly successful, these achievements also came at the cost of the creation of a diversity of technical and economic operating regimes.

Although highly successful in the technical area, SOCAR has been not been a financial success. SOCAR is burdened with social subsidization responsibilities in the oil, gas and electricity sectors. SOCAR delivers oil to government-owned and operated refineries at below world market prices, gas is delivered to Azerigas and Azerenergi without payment and heavy fuel oil is provided to power plants with zero payment. In the mean time, SOCAR is accumulating enormous tax arrears and tax penalties, making it appear unsuccessful in a business sense. The GOAZ has created a huge Quasi-Fiscal Deficit, estimated at 13% to 27% by the IFIs, in large part on the back of SOCAR. The burden of this social subsidy program is preventing SOCAR from participating as an equal partner within the AIOC consortium in the exploration, production and transportation of petroleum resources. The GOAZ now realises that this situation can no longer continue, if SOCAR is to be successful and thrive as an international petroleum company in the future. Therefore, the GOAZ has decided that SOCAR must be relieved of the negative economic effects of domestic utility and refining sectors' subsidization.

The development of the domestic electricity and gas utility sectors throughout the 1990s followed a more typical post-Soviet pattern. Both Azerigas and Azerenergy faced a number of problems that, by the end of the decade, left both organizations starved of funds and with inadequately maintained physical assets.

Probably the most important factors driving the results of the domestic energy utilities sector were the inability of the operating companies to collect payment for their

services, and the use of the companies as a subsidy implementation tool by the GOAZ.²

The first of these problems – the inability to collect full payment for services – was caused by many of the same factors as in the utility sectors of other Former Soviet Union (FSU) countries. These factors included lack of commercial operating focus, corruption (at both high and low levels), high loss rates (including theft), and both direct and indirect pressure to continue services to non-paying State enterprises. By the late 1990s, Azerenergy estimated that its overall cash collection rate was only 10-15 percent; Azerigas (perhaps optimistically) reported rates closer to 55-60 percent. Neither company was or is making payments to its sole fuel supplier, SOCAR.

The second major problem – the use of the companies as tools of government subsidy policy – also had some similarities to the experience in other FSU countries. Broadly, government policy at the time was that the population generally should enjoy the benefits of the country's oil and gas resources through implicit subsidies. It attempted to achieve this directly by maintaining lower-than-market transfer prices for oil products and gas from SOCAR to the domestic utilities, and indirectly through toleration of non-payment, tariff cross subsidies, and unsustainably low tariffs for utility infrastructure. Complicating this subsidy problem was the existence of (variously estimated) over a million refugees and internally displaced persons (over 11 percent of the population), arising from the conflict with Armenia.

By the end of the decade, the World Bank and IMF estimated the aggregate cost of these direct and indirect subsidies (including effective subsidies granted through toleration of non-payments) to be in the 13 to 27 percent of GDP range (the so-called "Quasi-Fiscal Deficit"). Furthermore, the decrepit condition of the domestic natural gas infrastructure had led offshore producers to consider completely bypassing the existing network and instead develop separate gas export pipelines, thus denying Azerigas future transit volumes and associated revenues.

Beginning in 1999, the GOAZ took the first of several steps to attempt to reverse the fortunes of the domestic utility sector. New electricity distribution companies were formed on the basis of the individual distribution enterprises held by Azerenergy. The GOAZ announced that the distribution companies would be tendered for long-term "management contracts" (that actually more closely resemble concessions) according to World Bank guidelines for international tenders. In November 2000, the GOAZ appointed Arthur Andersen (together with local lawyers and technical experts) as lead transaction advisor, and by December 2001, the first electricity distribution company (Bages, the Baku region distribution company) was transferred to Barmek (a Turkish company).

At the time of the writing of this report, bids were being evaluated for the remaining three electricity distribution companies (covering the remainder of the country with the exception of the Nakhichevan enclave). In addition, preparations were underway, subject to final GOAZ approval, for the release of tenders for management contracts for the Baku region gas distribution company, as well as, the Apsheron water company. We note that it is generally agreed that these transactions are proceeding in an environment of a less-than-complete legal and regulatory framework, with the GOAZ and investors apparently relying on individual contracts for security in a manner analogous to the use of PSAs in the upstream sector. For some areas of policy, the State Property Fund (now part of the Ministry of Economic Development) is in effect identifying and addressing issues on an ongoing basis through the negotiation of these contracts.

² This is not to minimize the importance of many other problems, including poor regulatory systems, poor reporting, lack of exercise of shareholder responsibility on the part of the GOAZ, etc.

In addition to taking these steps to introduce private sector participation into the utility sector, the GOAZ has also reorganized several important functions related to the sector. In April of 2001, the government created a new Ministry of Fuel and Energy. This ministry is to be responsible for energy sector policy and regulation (probably among other functions), but it is generally agreed that it has not yet fully defined or implemented its role. The sector operating companies have now been formally subordinated to this ministry and are to concentrate on commercial activities exclusively.

Also in April of 2001, the government combined the functions of three organizations – the Ministry of Economy, the State Property Committee, and the Anti-Monopoly Committee – into a new Ministry for Economic Development. This organization now also heads the recently created “Tariff Committee” (responsible for all utility tariff levels), with the participation of the Ministry of Fuel and Energy, the Ministry of Finance, and possibly others. The IFIs see this new commission as a positive first step toward the (IFI-encouraged) future creation of a truly independent, specialist, utility regulatory body.

On 25 March, a widely awaited Presidential Decree on payment discipline in the energy sector was released. The mission team has not had the opportunity to review this decree, but we have been given to understand that it was developed in response to the conditionalities of the IFIs. If so, it should represent another positive step toward reform in the sector.

DONOR AND IFI TECHNICAL ASSISTANCE ACTIVITIES

The multilateral IFIs and other donors, as well as, several bilateral organizations are active in Azerbaijan. Relevant highlights of their activities include:

- **The World Bank**

The Bank’s lending program includes some project lending in the energy sector (natural gas metering, environmental issues, and others), but probably more immediately relevant are its Institution Building Technical Assistance (IBTA) and Structural Adjustment Credit (SAC) programs. The latter program is a \$60 million credit that includes a number of conditionalities, approximately a third of which pertain to the energy sector. These are all largely aimed at achieving reductions in the Quasi-Fiscal Deficit. The Bank intends to use the conditionalities of this credit, together with funds from the IBTA to put in place at least some of the necessary technical assistance for the sector, although the actual timing of such technical assistance is not at all clear. Attachment 3 includes several TORs already drafted by the Bank in this regard. The Bank has expressed a desire for co-funding or other cooperation in these areas of technical assistance. The Bank has also noted that the GOAZ has not yet shown considerable willingness to borrow funds to support technical assistance activities.

- **The European Bank for Reconstruction and Development (EBRD)**

The EBRD has fifteen signed projects in Azerbaijan, amounting to some Euro 260 million. Several of these are to private companies operating in the upstream oil and gas sector. In the domestic utility sector, there have been two loans for power station rehabilitation (at the Yenikend hydro station and at the Mingchevir power station). The EBRD plans to sponsor a least-cost planning study in the electric power sector later this year to identify further needs.

- **EU TACIS**

The TACIS program has provided some significant technical assistance to the energy sector in the past, notably including assistance in defining the role for a Ministry of Fuel and Energy, assistance in drafting the initial Bages management contract, and also in upstream-related environmental areas. The current program undergoing tender (the 00/01 budget program) has cut back on energy and infrastructure. Apart from some continued support to the Ministry of Fuel and Energy for the first part of this calendar year, it appears as if TACIS will not return to the energy sector in any significant sense for perhaps several years.

- **Kreditanstalt fuer Wiederaufbau (KfW)**

KfW has assisted in an electricity transmission rehabilitation project (DM 30 million in 1999, tied to an IDA credit) and is currently attempting to develop a second Euro 15 million project for substation rehabilitation. There is no work related to the legal and regulatory framework in the energy sector.

- **International Monetary Fund (IMF)**

In addition, the IMF is working closely with the multilateral IFIs on defining relevant energy sector conditionalities and on improving macro-level statistical reporting.

ASSISTANCE NEEDS IDENTIFIED BY AZERBAIJANI COUNTERPARTS

The Mission Team's discussions with Azerbaijani counterparts elicited a number of suggestions of areas where assistance would be seen as useful. Table 1 sets out these suggestions. As we note in the recommendations that follow, we have not at this stage attempted to either rationalize or evaluate these "self-reported" needs. It is worth noting that the majority of the recommendations were at least in the nature of technical advisory assistance, rather than procurement or other direct financial support.

RECOMMENDATIONS

The work of this Mission has suggested a number of appropriate next steps. In approximate order of urgency, these include:

1. The March 25 Presidential Decree on energy sector reform policy should be reviewed to assess whether a short-term advisory group should be deployed to assist the GOAZ in carrying out the elements of the decree tied to World Bank and IMF conditions. This work should be co-ordinated with the World Bank and IMF, if undertaken. (Decree in Attachment 3).
2. After review of the March 25 Presidential Decree, World Bank, and TACIS TA programs, a further, larger scale and scope delegation should return to Azerbaijan and re-examine the self-reported needs and assess further unidentified needs to develop a comprehensive and coherent program proposal. This proposal should include a review of the World Bank SAC conditions and identify the technical assistance "gaps" and programs needed for the energy sector and GOAZ to meet these conditions. Although the GOAZ and World Bank and IMF have apparently reached an understanding on a set of targets, it appears that the GOAZ does not yet have a detailed implementation plan for how to achieve these targets.

Following these two immediate steps, a coherent technical assistance program, consistent with other ongoing efforts, could be developed. Without prejudging the results of that program development, at this stage several potential areas of assistance will likely be needed:

3. Develop a plan to assist the GOAZ to continue the electricity distribution privatization, mini-hydro privatization and future gas privatization activities. Especially in the natural gas distribution sector, near-term commercialization and pre-privatization activities are likely useful.
4. Examine, on an expedited basis, the draft natural gas law. Also, complete a thorough legal review of the current electricity and energy laws.
5. Develop a plan to assist the new Tariff Committee and to formalize the tariff setting process to transition systematically towards cost-based tariffs within the GOAZ 's planned timing (3 years) while also addressing the concerns of the socially vulnerable.
6. Assist the GOAZ to develop financial / operational performance indicators that can be used to track the GOAZ compliance with the Sector Adjustment Credit (SAC) conditions. It should be noted that if this work is pursued, coordination with IMF efforts is required.
7. Assess the need for further physical development projects (e.g., Mingechevir No. 9, electricity transmission projects and gas transport development) to ensure that they support (or do not unduly hinder) the further reform and privatization of the energy sector. We note that if this work is pursued, it should be coordinated with the EBRD's upcoming least-cost planning study.

Table 1: Self-Reported Assistance Needs	
Source	Areas of Work
Ministry of Fuel and Energy	<ol style="list-style-type: none"> 1. Development of an energy sector database 2. Physical rehabilitation of the natural gas system 3. Development of unified technical standards for offshore / upstream development
Azerenergy	<ol style="list-style-type: none"> 1. Scada system procurement and implementation 2. Commercial / management training 3. Improved operational efficiency in generation / transmission 4. Assistance in mini-hydro privatization
Arthur Andersen (GOAZ transaction advisor for electricity distribution)	<ol style="list-style-type: none"> 1. Training of / Assistance to GoAz "contracts manager" for distco contracts
Azerigas	<ol style="list-style-type: none"> 1. Further development of gas sector legal and regulatory framework
Multiple sources	<ol style="list-style-type: none"> 1. Further improvement in tariff methodologies / regulatory procedures 2. Management / commercial training 3. Legal and regulatory framework
Ministry of Economic Development	<ol style="list-style-type: none"> 1. Establishment of a National Dispatch Center in the power sector 2. Implementation of improved metering 3. Efficiency programs and training for both the energy and water sectors 4. Improved tariff methodologies and general support to the new Tariff Commission 5. Assistance with the management contract and related issues in the gas sector 6. Promotion of alternative energy sources
SOCAR	<ol style="list-style-type: none"> 1. Improvement in collections and implementation of the 25 March Decree

In-Briefing Meeting: Ambassador Wilson and DCM Nancy McEldowney

Date: 25 March, 2002

Attendees: Herb Emmrich, Eka Aladashvili and Tom Olsen,
USAID/Caucasus; Dean White, PA Consulting; Debra
Juncker, US State Department.

Discussion Summary:

Ambassador Wilson welcomed the USAID/Caucasus Mission Energy Sector Assessment Team (team) to Azerbaijan and briefed the team about his concerns and reasons for requesting an energy sector review. Ambassador Wilson said that he had been talking with the IMF representative in Azerbaijan, Michael Mered, as well as the EBRD and World Bank representatives about the Azerbaijan energy sector reform program. The IFIs believe that the USAID reform programs developed in other CIS countries would be very helpful in assisting the GOAZ to meet IFI energy sector conditions. The GOAZ needs help in carrying out the energy sector reforms that it has agreed to in the latest World Bank Structural Adjustment Credits (SAC) conditions. The IFIs have stated to the Ambassador that the GOAZ probably does not exactly know what it signed up for when they agreed to the SAC conditions. The Ambassador wants the IMF program to be kept on track and therefore technical assistance should be designed to help the GOAZ meet the IFIs' conditions.

Based on this background, the Ambassador asked USAID to send in an advanced energy sector review mission followed by a more in depth assessment of the kind and scope of assistance that would be most beneficial to help the GOAZ meet IFI conditions. The Ambassador suggested that, after the team's initial review, a team headed by Robert Ichord, USAID/W would be most helpful given Ichord's vast experience in energy sector reform throughout the CIS and Eastern Europe.

The Ambassador noted that Medjid Karimov, the new Minister of Fuel and Energy, needs assistance in all areas of institution building at this time because he has a very inexperienced staff and management team reporting to him. Due to this lack of experience, the Ministry of Fuel and Energy has not been effective in gaining control over their areas of responsibility. Given the inexperience of the new Ministry of Fuel and Energy staff, Farhad Aliyev, the Minister of Economic Development, has been more effective and proactive and has been the leader in energy sector and overall economic reform effort to date. However, the Ambassador believes that in order for the energy sector reform initiatives to succeed, the new Ministry of Fuel and Energy needs technical assistance and training to carry out its responsibilities.

The Ambassador asked the team to review the desire and need for assistance in the entire Azerbaijan energy sector and to report back to him at the closeout of the assessment mission. The Ambassador asked a US Embassy representative to accompany the team in meetings with GOAZ officials. The team thanked the Ambassador for his support and the support of Embassy staff in advance of the team's arrival

Out-Briefing Meeting: Ambassador Wilson

Date: 28 March, 2002

Attendees: H. Emmrich, E. Aladashvili, T. Olsen,
USAID/Caucasus; D. White, PA Consulting; Richard
McCrensky, US Embassy.

Discussion Summary:

- Ambassador Wilson asked the team to give a brief summary of its findings.
- Herb Emmrich gave a brief summary of the meetings with GOAZ counterparts, energy sector managers, IFIs and other persons interviewed during the week. Emmrich reported that all Azerbaijani officials and the IFIs operating in Azerbaijan, welcome USAID assistance and are looking forward to USAID's participation in the further development of the Azerbaijan energy sector. Specifically:
 - Technical assistance is needed and requested by the GOAZ and the IFIs in order to help Azerbaijan reduce the Quasi-Fiscal Deficit currently estimated by the IFIs to be from 13% to 27% of GDP depending on different assumptions.
 - Currently, there is no modern legal or regulatory basis for the development or privatization of the energy sector. A full legal and regulatory structure needs to be developed and a legal and regulatory staff should be trained if Azerbaijan is to modernize and efficiently regulate its energy sector.
 - Over the longer-term, institution and human resources capacity building is needed if the Azerbaijan energy sector is to meet international operating and management standards.
 - In order to carry out its regulatory functions, the Ministry of Fuel and Energy will need longer-term institution and human resource capacity building assistance.
 - A short-term advisor would be useful to assist the GOAZ to construct a database to track the conditions of the IFIs tied to the current World Bank SAC.
 - After review of other donor's assistance programs, a decision should be made to more fully explore the kind of energy sector assistance program USAID can implement in Azerbaijan to help develop the sector effectively.

Ambassador Wilson

Ambassador Wilson thanked the team for their report and asked about the effectiveness of a short-term advisor and how USAID could possibly provide such assistance. There was a brief discussion about possible contract vehicles available to provide such assistance. The team promised to get back to him after discussion at the USAID/Caucasus mission and further co-ordination with other donors concerning their assistance plans. (Note: The following report was used to brief the Ambassador.)

SUMMARY OF FINDINGS

March 28, 2002

EVENTS

- A new Ministry of Fuel and Energy was created in April 2001. It has received some support from the Tacis program and will receive further support in the future. It is generally agreed, however, that the Ministry has yet to fully grasp its policy roles.
- Three government organizations – Ministry of Economy, Anti-Monopoly Commission, and State Property Fund – were grouped into the Ministry of Economic Development in April of 2001. This Ministry has been, and continues to be, influential in energy sector privatization, and, by default, creation of the beginning of various energy sector commercial regulations. It retains the lead role on tariff issues within the Government.
- Energy sector privatization began with the award of a 25-year management concession for the Baku electricity distribution company in December of 2001. Tenders have now been received for concessions for the remaining three distribution companies. Plans for similar management contracts for Baku gas distribution and water distribution companies are being held by the Ministry of Economic Development awaiting executive orders. Concessions for electricity generation may also be considered in the near future.
- The World Bank lending program (Structural Adjustment Credit, IBTA, etc) includes energy sector covenants developed with the IMF generally related to the reduction of the Quasi Fiscal Deficit. In addition to the overall reduction of the deficit, specific actions (elimination of untargeted subsidies, improvement of collections, increase in oil / gas transfer prices to world levels) are also identified.
- An inter-ministerial Tariff Commission was established approximately one month ago. This commission, headed by the Minister for Economic Development, includes other representatives of other ministries (e.g., Ministry of Fuel and Energy, Ministry of Finance) and others. It will take over responsibility for all national tariff setting in energy, water, and possibly other areas. The commission was established pursuant to IFI conditionalities requiring an “independent” regulatory commission; the EBRD sees the current commission as a positive first step in this area. A possibility could be that this inter-ministerial body form the core of a regulatory body at a later date.
- On 25 March, a Presidential Decree on energy sector reform policy was issued pursuant to IFI conditionalities. The team has not had the opportunity to review this decree, however we understand that it should include directions regarding energy payments by state enterprises, and other issues related to IFI concerns.

SELF-REPORTED NEEDS

- The Ministry of Fuel and Energy identified its own needs in three areas: development of an energy sector database, physical rehabilitation of the natural gas transport system, and development of technical standards according to international norms (e.g., offshore drilling standards).
- Azerenergy identified operational inefficiencies of generation and transmission sectors as important needs, as well as improvements in system dispatch capability (e.g., SCADA, and management training), and training, especially in commercial (e.g., finance / accounting) areas. Azerenergy will also this year receive technical assistance in the development of a Least Cost expansion plan through the EBRD.
- Andersen identified that the Government will continue to need assistance with developing concessions and privatisation transactions, as well as with managing / negotiating tariff and planning issues arising from the initial concession transactions. An important milestone in the initial electricity distribution contract (presumably to be repeated in other distribution companies) occurs at twelve months where the Government will need to re-evaluate investment proposals and other issues raised by the new operating companies.
- Azerigas has noted that although Parliament is considering a new law on gas, further development of the legal and regulatory framework would be useful.
- There was general agreement that development of tariff methodologies (including customer and time-of-day differentiation, as well as overall levels) and regulatory procedures for the new tariff commission would be useful.
- There was general agreement that management training (particularly in commercial areas) would be useful.
- The World Bank has already identified several projects (and drafted TORs) in several energy-related areas. It currently hopes to fund these through grants or soft loan money; it would be pleased to receive assistance from bilateral donors.
- Kerim Ramazanov (former member of parliament and Director of the Energy Research Institute) believes that further development of the legal and regulatory framework is necessary, as well as development of the Tariff Commission and its eventual transformation into a truly independent regulatory commission, and further management training throughout the sector.

NEAR-TERM ACTIONS

- The 25 March Presidential Decree on energy sector reform policy should be reviewed to assess whether a short-term advisory group should be deployed to assist the GOAZ in carrying out the elements of the decree tied to World Bank / IMF conditions.
- Review the World Bank SAC conditions and identify the TA "gaps" and programs needed for the energy sector and GOAZ to meet these conditions.
- Assist the GOAZ to develop financial / operational performance indicators that can be used to track the GOAZ compliance with the SAC conditions.
- Develop a plan to assist the GOAZ to continue the electricity distribution privatization, mini-hydro privatization and future gas privatization activities. Especially in the natural gas distribution sector, near-term commercialization / preprivatization activities are likely useful.
- Assess the need for further physical development projects (e.g., Mingechevir Unit No. 9, electricity transmission projects and gas transport development) to ensure that they support (or do not unduly hinder) the further reform and privatization of the energy sector.
- Examine, on an expedited basis, the draft natural gas law. Also, complete a thorough legal review of the current electricity and energy laws.
- Develop a plan to formalize the tariff setting process to transition systematically towards cost-based tariffs within the GOAZ's planned timing (3 years) while also addressing the concerns of the vulnerable.
- After review of March 25 Presidential Decree, World Bank and TACIS' TA programs, a further, larger scale / scope delegation should return to Azerbaijan and re-examine the self-reported needs to develop a comprehensive and coherent program proposal.

Attachment 1: Principal Contact List

Norali Yusifov, Chief Dispatcher of Azerenergy
Medjid Kerimov, Minister of Fuel and Energy
Etibar Pirverdiyev, President, Azerenergy
Peter Burnie, Arthur Andersen
Adilchan Melikov, Chairman Azerigas
Farid Mamedov, Operations Officer, World Bank
Kerim Ramazanov, Director of the Scientific Research Institute of Energetics and Energy Design
Michael Mered, Resident Representative, IMF
Jamal Pashayev, Financial Analyst EBRD
Huseyin Arabul, Chairman, Barmek Azerbaijan Electric Distribution Company
Jahangir Kasimov, Director, TACIS National Coordination Centre
Marcel Schwickert, Head of Office, GTZ
Farhad Aliyev, Minister of Economic Development
Rafiq Aliyev, Special Advisor to the President, SOCAR

Attachment 2: Meeting Notes

Meeting Counterpart: Norali Yusifov, Chief Dispatcher of Azerenergy and Mr. Jamgulayev Azadov, Mingechevir Power Plant Director

Date: 24 March 2002

Attendees: Herb Emmrich and Eka Aladashvili, USAID/Caucasus; Dean White, Levan Mtchedlishvili, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan. Emmrich explained that USAID is an agency of the US Government that works in co-operation with a host country to provide assistance programs that lead to sustainable economic and social development. USAID's approach is to design mutually beneficial development programs and then work co-operatively with the host country and other donors to attain shared goals. USAID's programs are usually longer-term with a strong emphasis on institution and human resources capacity building. In many instances, USAID works in concert with the International Financial Institutions (IFI) to provide technical assistance and training that enables the host country to meet the condition set by the IFIs for grants and credits. To date, USAID has concentrated its assistance in Azerbaijan on humanitarian relief, small and medium-sized business and an independent press development. USAID is now looking to see if Azerbaijan wants assistance in the energy sector and to assess if there is a useful role for USAID in this sector. (Note: A similar explanation of USAID's assistance approach was presented at each subsequent counterpart meeting. End note.)
- Norali Yusifov, Chief Dispatcher of Azerenergy and the Mingechevir Power Plant Director gave a tour of the 2,400 MW Mingechevir thermal power plant. Eight 300 MW units are operating on a combination of fuel oil and gas. A ninth unit, also at 300 MW, is about 70% completed and would require an additional \$50 to \$60 million to make operational.
- The plant is in relatively good condition, given its age and looked well maintained. The control room is old and out of date and is in need of modernisation. The plant manager listed as his first priority the upgrade of the control system in order to increase the efficiency of the plant, then the completion of unit 9 and finally a major overhaul of units 1 through 8.
- When asked if the staff was being paid, he stated that there are salary arrears but the workers work because they are patriotic.
- The meeting was conducted in a frank and friendly fashion with a good exchange of views and an appeal for assistance in all areas of the plant from facilities upgrade to training of management and staff.

Meeting Counterpart: Medjid Kerimov, Minister of Fuel and Energy
Date: 25 March 2002
Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, Kirby Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting; David Letteney, US Embassy.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- The Minister stated that the Ministry of Fuel and Energy was established about a year ago. Among its goals is to promote the development of an effective market-based energy sector in Azerbaijan. Three operating companies are subordinate to the Ministry: Azerenergy, Azerigas, and SOCAR.
- The Ministry is beginning to take some control over setting the framework for the development of the energy sector. However, some of these functions are still embedded in the operating companies (particularly within SOCAR).
- The Ministry also participates in the new (approx. one month-old) tariff committee which is led by the Ministry of Economic Development. The work of the tariff committee is still undergoing definition.
- The Minister identified three principal areas in which assistance would be useful:
 1. Development of a data base for the fuel and energy sector. This database would track operating and financial information for the three energy sector operating companies.
 2. Physical rehabilitation of the natural gas system (especially the domestic high-pressure system), together with the development of a concept paper for the organisation, operation, and governance of the sector in the future.
 3. Assistance with identification and implementation of necessary technical standards. The minister specifically noted offshore production standards as necessary (today, each PSA operator effectively maintains its own approach to standards).
- The minister was relaxed and friendly in the meeting and thanked us for the visit. He said he was open to all kinds of assistance and looks forward to future co-operation. Herb Emmrich stated that USAID will review the needs of the Ministry of Fuel and Energy and co-ordinate with other donors to see if there is a role for US assistance in the future.

Meeting Counterpart: Etibar Pirverdiyev, President, Azerenergy

Date: 25 March 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting; Debra Juncker, US Embassy.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Mr. Perverdiyev gave an overview of the electricity sector. He stated that most generating units are 25 years old and many need to be shut down because they are inefficient and cause environmental problems. He noted several ongoing construction projects in generation (including, e.g., the Mitsui 400 MW project, the recent commissioning of two 110 MW units at the Baku districting heating plant, and further plans possibly at Ali Bayramli and Mingchevir).
- The Baku electricity distribution company has recently been placed under a 25-year long-term management contract, and bids have now been received for management contracts at the three remaining distribution companies (Gendje, Sumgayit, and Ali Bayramli; these exclude the territory of Nakhichevan). There are 4-5 bidders for each of the remaining companies.
- The Minister believes that Barmek is working well, but notes that they have seen data for only a few months of operation so far. The Barmek contract calls for achieving 50% collections in the first year, and then increasing that level to 100% over five years. In February, according to the minister, the company achieved 50% collections. Overall collections in the sector are about 30% (cash), excluding Barmek. (Note: In a later meeting with Huseyin Arabul, the president of Barmek, Arabul stated that collections are about 25% to 30% right now. End Note).
- After electricity distribution is transferred to the private sector, attention will probably turn to generation. Already a presidential decree has been issued allowing mini-hydro facilities (5 MW maximum) to be privatized. Transmission and system operation will always stay state-owned and operated.
- Issues of both technical and economic regulation, as well as market development have yet to be fully resolved. He expressed a need for rules and regulations and a sound legal basis to further the development of the electricity sector. Specifically with regard to tariffs, a new tariff commission has been set up a month ago. It is headed by the Ministry

of Economic Development, with the participation of the Ministry of Fuel and Energy and the Ministry of Finance.

- Metering is adequate and fully time differentiated at the border of Azerenergy and its four customers (i.e., the four distribution companies). There is a lack of sophisticated metering downstream from there.
- Tariffs for end-users lack time differentiation and also are apparently poorly differentiated across voltage levels. There is an urgent need to develop time-of-use tariffs to reduce peak demand on the system and to promote the efficient use of electricity.
- Pirverdiyev noted that Azerenergy's major challenges for the future included development and rehabilitation of generation stations and also completion of high voltage (500 kV) transmission lines to Georgia (to facilitate electricity export sales to Turkey to offset the power deficit in Nakhchivan). In addition, Azerenergy is considering the construction of a high voltage (300 kV) transmission line from Russia to Azerbaijan. The specification and implementation of a SCADA system for despatch is desired. The President also noted that training, particularly in commercial and financial areas, would be useful. Some progress has already been made in rationalising the company's organisation and employment levels.
- The meeting was conducted in a friendly manner with a good exchange of views. The President stated that US assistance is welcomed and he looks forward to future co-operation with USAID. H. Emmrich stated that after co-ordination with other donors and further discussions with Azerbaijan officials possible US assistance to the energy sector may be considered.

Meeting Counterpart: Peter Burnie, Arthur Andersen

Date: 26 March, 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- P. Burnie, the Government of Azerbaijan's investment banker for electricity distribution company privatization, described various aspects of the Barmek contract. The firm took over operations at Bages officially as of January 2002, following a one-month overlap period in December. The contract extends for 25 years, although Barmek will not be fully committed until after a review of investment and business plans following the first 12 months of operation.
- In terms of tariffs, the contract calls for holding tariffs fixed on both the buy-side and sell-side for three years. This effectively gives Barmek a fixed margin during this period. Burnie stated that the contract was drafted to allow substantial flexibility for future changes in tariff, tariff procedures and so on. (The team would later note that this seemed to be a slightly different interpretation than that provided by the President of Barmek).
- Burnie believes that the government could use assistance in managing the contract, particularly in view of the important upcoming review of the Barmek contract following 12 months of operations. Also, commercial training for the sector and further public awareness campaigns might be useful.
- Bids have been received for the remaining three electricity distribution companies. There are a total of 4 different companies bidding, and most have bid for more than one distribution company. (Note: In the *Caspian Business News*, dated March 27, 2002, p. 4, it stated that the four companies are: Azeri companies Improlex and Baki Yuksk Gerginlik Elektrik Avadanligi; Turkey's Elektrik Ticaret; and, a US company named Vulford. Although Burnie stated that Barmak was not one of the bidders, we later found out from Barmek President Arabul that Barmek has bid for Sumgayit and was in fact asked by Anderson to submit a bid. End note).
- The government has decreed that mini-hydros (9 separate units, each less than 5 MW) will be fully privatized (rather than placed under management contract). However, the government has given no thought to commercial arrangements (grid access, trading, etc) for the units.
- The meeting ended on a friendly note with future co-operation being offered by both sides.

Meeting Counterpart: Adilchan Melikov, Chairman Azerigas

Date: 26 March, 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting; D. Letteney, US Embassy.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Chairman Melikov described background information on Azerigas. Since late 2000, Azerigas has been receiving gas from both SOCAR and Russian imports (purchased through SOCAR). Imports for 00/01 were about 2.5 billion cubic meters (bcm) with total annual needs in excess of 5 bcm. Over the course of the next 5 years imports will increase, and total annual demand will be in the range of 7-8 bcm.
- There is a substantial need for rehabilitation of the gas transport system, including especially the high-pressure network and compressor stations (today, compression is achieved through the interconnection to Russia); a Japanese credit is being used to rehabilitate some of the northern pipeline route. There are two underground storage facilities with nominal capacity of 5 bcm, but today are only capable of 0.5 – 0.6 bcm. Rehabilitation will be necessary to return to the 5 bcm capacity.
- There is a need for a SCADA system. A feasibility study has already been completed, however Azerigas lacks the financial resources to implement the system.
- The Shah Deniz gas will be transported through a separate high-pressure pipeline system. Azerigas is hoping to interconnect to the Shah Deniz export pipeline at Mingechevir.
- Azerenergy is the single largest user of gas. Domestic users are supplied only near "regional centres". There is insufficient (or, perhaps, un-rehabilitated) infrastructure to supply more remote consumers.
- Chairman Melikov asserted that payment rates for domestic users are in the range of 55-60%, but collections from Azerenergy are zero. Tariffs are below the cost of gas (e.g., Azerigas purchases gas from SOCAR at 66 manats per cubic meter and the domestic tariff is only 35 manats per cubic meter). He sees no possibility of increasing domestic tariffs in the near future. Azerigas does not pay SOCAR and Azerenergy does not pay Azerigas. As a result all of the companies have accumulated tax arrears and are now accumulating tax penalties.

- Metering is a problem: there are about 42,000 consumption meters in place, but over 400,000 customers in the Baku region alone. Un-metered consumers are billed according to norms of consumption. At the interface between the high-pressure and low-pressure systems, Melikov claims that there is complete metering. (Note: Later discussions with the World Bank confirmed that perhaps as much as 60% of the necessary metering is not installed. End note).
- Chairman Melikov agreed that there was a need for training and upgrade of skills, although the precise areas in which this was needed was not specified. He also agreed that improvements to the legal and regulatory framework for the industry were needed.
- A study (World Bank-sponsored) by the consultants NERA has begun, but the consultants are not yet very much engaged with Azerigas.
- Azerigas has a 2000-2005 development plan which Chairman Melikov agreed to provide to the team.
- The meeting was friendly and open with requests for US assistance in all areas. H. Emmrich stated that after consultation with other donors and further discussions within the US Government possible future assistance needs will be evaluated.

Meeting Counterpart: Farid Mamedov, Operations Officer, World Bank

Date: 26 March 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Farid Mamedov summarised the Bank's activities. Azerbaijan is currently an IDA-eligible country, although the Bank's IDA program is limited to \$20 million annually, restricted to the social sector. This level of funding is not likely to be changed until at least 2004.
- In mid-2001, the Bank agreed to a \$60 million Structural Adjustment Credit for which approximately 30% of the conditionalities were energy-sector related. The principal thrust of the energy sector conditionalities was to require a 30% reduction in the Quasi-Fiscal Deficit currently estimated at 13% to 27% by the World Bank and International Monetary Fund respectively. The recently signed Presidential Decree on payment discipline in the energy sector was in part driven by the SAC conditions.
- An appraisal team will come to Azerbaijan next month to assess progress on SAC conditions and to develop the necessary technical assistance (TA) program for the energy sector. Apparently the World Bank has some \$6 million set aside for TA and they would be pleased to receive co-funding from bilaterals.
- Mamedov noted also that some movement has been seen in terms of getting Bakgas (the Baku gas distribution company) and Apsheron Su (the Apsheron water distribution company) tendered for long-term management contracts. Apparently the Ministry of Economic Development is awaiting only official presidential confirmation. The Bank is already attempting to hire an advisor for the Bakgas transaction under its existing IBTA credit.
- Tariffs for all utilities are now handled by a newly created (one month old) Tariff Commission. The Commission is headed by the Minister for Economic Development, with participation of the Ministry of Fuel and Energy and Ministry of Finance. The first action of the new commission will be to consider a proposed 15 percent increase in water tariffs later this week. Mamedov confirmed that the Tariff Commission will need assistance in the future.

- In terms of legal development, the EU is taking much of the lead due to the linkages with accession to the Council of Europe.
- The IMF has recently begun a project to develop quarterly reporting in the energy sector. Experience in other countries suggests that it will be several years before reliable data can be obtained through this form of reporting.
- Mamedov agreed to provide a set of relevant World Bank documents to the team (later received by e-mail).
- The meeting was conducted in a friendly manner with future co-operation and co-ordination of assistance promised by both sides.

Meeting Counterpart: Kerim Ramazanov, Director of the Scientific Research Institute of Energetics and Energy Design

Date: 27 March 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Ramazanov sees the top priority for the power sector as the rehabilitation of power stations. He noted the progress already made in putting Bages under management contract and confirmed that bids were being analysed for the remaining three electricity distribution companies (Ramazanov sits on the evaluation committee for these, just as he did for Bages). He agreed that the Turkish company, Barmek, seems to be operating well, but noted that there are only a few months of experience.
- Ramazanov's institute is working with the Ministry of Fuel and Energy on the preparation of technical licenses for the power sector.
- He believes that the most important area of work for the Ministry of Fuel and Energy will be in guiding the development of the oil, gas, and electricity sectors in the future. So far, it is difficult to assess the progress of the Ministry, since it is only a year old. There was further discussion on his opinion of the future role of the Ministry particularly with regard to the separation of policy / government functions from SOCAR.
- Ramazanov agreed that there is a need to further develop regulations on tariff methodologies and procedures. He also sees a need for training, particularly in commercial areas for industry personnel.
- The meeting was very friendly, open and frank. Professor Ramazanov offered the use of his institute's facilities for future training of energy sector staff and management. H. Emmrich stated that possible future assistance to Azerbaijan needs to be co-ordinated with other donors and US and Azerbaijan government officials. This is to assure that possible future assistance is effective and is conducted in a co-operative manner.

Meeting Counterpart: Michael Mered, Resident Representative, IMF

Date: 27 March 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting; D. Juncker, US Embassy.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Mered stated that the IMF is encouraging the government of Azerbaijan to reduce their huge energy sector subsidies to a reasonable level. Currently the IMF estimates the Quasi-Fiscal Deficit, attributed to energy sector subsidies, at 27% of Gross Domestic Product. (Note: This estimate is much larger than the World Bank's estimate of 13%. End note). He said that an energy sector reform program is needed in Azerbaijan to reduce this deficit. At this point, the GOAZ has decided that the current subsidy system can not be maintained and that reform is the only viable option. There has been a recent change in attitude about reform and the recently issued Presidential Decree on energy reform is a confirmation of that fact.
- Technical assistance will be needed for the Ministry of Fuel and Energy to play a role in this reform effort. In addition to energy sector reform, taxes and customs duties are being reviewed to get them in line with WTO standards. Azerbaijan is starting the process to join the WTO.
- The GOAZ oil fund is now at \$700 million. When the oil fund reaches \$1 billion, the government will start to use oil funds to increase spending in the health and education sectors.
- Mered directed the team to the IMF web site to obtain the latest IMF assessment of the Quasi-Fiscal Deficit. He also noted that the recent (25 March) presidential decree on energy reform was driven by IMF / WB conditionalities and should be consistent with the SAC program.
- Mered sees the Ministry of Fuel and Energy as an important step in the continued separation of policy roles from commercial roles in the energy sector operating companies. As for the new ministries particular duties, he prefers (as a macroeconomist) to defer to energy sector experts.
- The meeting was very cordial and Mered offered IMF co-operation and continued co-ordination of assistance measures. H. Emmrich stated that future co-operation and co-ordination of donor activities are essential to assure effective use of limited assistance resources.

Meeting Counterpart: Jamal Pashayev, Financial Analyst EBRD
Date: 26 March, 2002
Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili; PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Pashayev provided a brief overview of the EBRD's activities in Azerbaijan. There have only been two energy sector loans, both to Azerenergy for power station rehabilitations (1994, \$53 million Yenikend hydro; 1997, \$22 million Mingechevir hydroelectric facility). Hard conditions tied to these loans for collections rates have not been met. The EBRD will soon be providing TA for a least cost study to assess the need for future Azerenergy loans. This study should begin within the next several months. The EBRD has determined that the \$50 million needed for the completion of unit 9 at Mingechevir would not be cost-effective and has declined requests to finance its completion.
- He noted that the negotiation of the World Bank's Sector Adjustment Credit (SAC) and the associated focus on the quasi-fiscal deficit has focused the attention of the government. He believes that the recent Presidential Decree on payment discipline in the energy sector is a direct result of this.
- It is too early yet to assess the effectiveness of the Ministry of Fuel and Energy. However, he believes that this Ministry could benefit through work aimed at further clarifying its policy role.
- The EBRD supports the concept of independent regulatory bodies generally. Pashayev sees the recent establishment of the Tariff Commission here as something which is an adequate first step in this direction and therefore (at this time) meets related SAC conditionalities.
- More assistance with commercialisation is generally needed within the sector. Azerigas is somewhat behind Azerenergy on all fronts, and SOCAR presents unique problems. Azerigas needs to be broken up into separate joint stock companies for distribution and transmission and then privatized.
- The meeting was very friendly and co-operative. The EBRD welcomes US assistance in all areas of the energy sector: TA and training in the legal and regulatory area being most essential at this time. H. Emmrich stated that continued donor co-ordination is needed to effectively use limited donor resources.

Meeting Counterpart: Huseyin Arabul, Chairman, Barmek Azerbaijan Electric Distribution Company

Date: 27 March, 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili; PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Mr. Arabul described Barmek's progress in Azerbaijan. He is confident that his management contract provides him with an adequately legal basis to conduct his business. He said that he has a Presidential Decree and a contract and does not need any other legal or regulatory measures to manage his business. If there is a dispute, he has an international arbitration clause in his contract that will protect him. He is not concerned with the lack of a sound legal and regulatory structure in the Azerbaijan energy sector. Under the contract terms, he has the right to set his own rules and regulations based on western standards.
- Specifically in terms of tariffs, Barmek has fixed electricity purchase costs from Azerenergy and fixed sales tariffs for three years, effectively providing a fixed distribution margin. Following that period, the tariff is governed by the contract. Barmek will be allowed to recover its investment cost in the tariff and any deficit in the cost recovery will be covered by a reduction in the purchase cost of electricity from Azerenergy. This means that all losses occurring to Barmek will be covered by Azerenergy. This scheme is no different than the current situation where losses in the distribution side are covered by Azerenergy and indirectly by SOCAR. (The team noted that his description appeared to suggest that the contract is more precisely prescriptive than Peter Burnie of Andersen suggested).
- Mr. Arabul stated that collections are about 25% to 30% right now. About 10,000 new meters have been set out of the 450,000 customers in Barmek's service territory. Arabul expects to spend \$10 million in 2002, all of it self-financed. Over the 25-year contract he expects to invest \$250 million. The contract provides for 100% currency devaluation protection and Barmek has the option to renegotiate the contract after one year or pull out. When asked about donor financing, he stated that he has no need for such financing. Barmek is a producer and supplier of electric equipment. A Barmek subsidiary, EMEK, is his equipment supplier.

- Work is proceeding on development of customer data bases, automation of record keeping and so on. The company currently has 2,500 employees but only 50% of that number are needed. About 50-60 Barmek experts currently work in Azerbaijan. He is instituting a separate company to handle meter reading, billing and collections. This new company will use hand-held computers to enter the meter read, issue the bill and collect the money. He is signing an agreement with the Telecom Ministry to run fiber optic cables to connect all Barmek facilities in Baku. This will include all substations and the dispatch center.
- Arabul meets with the Prime Minister monthly for status reports.
- At the end of this calendar year (12 months following the start of Barmek's work), there will be a review of investment plans, loss levels, etc. It is at this point that Barmek will decide to stay or leave depending on the outcome of negotiations.
- The government has recently appointed a contract manager (from the Ministry of Economic Development), but Arabul has not yet met with him.
- The meeting was very open and interactive. Mr. Arabul is a dynamic personality who has a vast amount of business experience. He is having fun and enjoying his many challenges but will take a hard businessman's look at the situation after one year and decide his future involvement in the Azerbaijan energy sector at that time.

Meeting Counterpart: Jahangir Kasimov, Director, TACIS National Coordination Centre

Date: 27 March, 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- The TACIS programme for 00 / 01 is only just being let for tender. There are no projects specifically targeted to energy, and recently all infrastructure projects (which were all in the transport sector) were cut from the program. With the reduction of infrastructure projects, the 00 / 01 programme is about 8.4 million Euro (this excludes regional programs such as TRACECA and INOGATE).
- The 98 / 99 program included a component to assist in the establishment of the Ministry of Fuel and Energy, as well as work related to the development of the Bages management contract. The assistance to the Ministry will probably be extended with about 0.8 million Euro through the end of July 2002. Further work there may be picked up in the 02 / 03 programme. No Terms of Reference (TOR) for the 02 / 03 program have yet been developed.
- There was discussion of IAS projects; originally the TACIS contractor had wanted to use an energy sector company as a pilot, but that idea was rejected by the government.
- The meeting was friendly and informative as to our mutual activities. Each side resolved to continue co-ordination to assure maximum effective use of limited assistance resources.

Meeting Counterpart: Marcel Schwickert, Head of Office, Gemeinschaft fuer Technische Zusammenarbeit (GTZ)

Date: 28 March, 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Mr. Schwickert described the work of GTZ which covers 5 areas: Integrated Food Security Programme, Privatisation, Legal Reform, Private Sector Development, and Agriculture. None of these programmes deals specifically with the energy sector.
- There was discussion of political and social contrasts between Azerbaijan and Georgia.
- KfW has assisted in an electricity transmission rehabilitation project (DM 30 million in 1999, tied to an IDA credit) and is currently attempting to develop a second Euro 15 million project on substation rehabilitation. There is no work related to legal / regulatory framework in the energy sector.
- The meeting was very open and frank with good discussions on our approaches to assistance in the Caucasus. It was agreed to continue our co-ordination in the future to assure better communication about our assistance programs.

Meeting Counterpart: Farhad Aliyev, Minister of Economic Development

Date: 28 March, 2002

Attendees: H. Emmrich, D. White, K. Owen, V. Vilayev, [US Embassy Rep], E. Aladashvili, L. Mtchedlishvili

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Minister Aliyev asked for further specific descriptions of AID's project work in both Georgia and Armenia. He expressed general interest in pan-Caucasus issues; he sees this as an important policy area for the future.
- In terms of specific Azerbaijani energy sector assistance, he sees potential for co-operation in several areas, including:
 1. Establishment of a national despatch center in the power sector.
 2. Metering at all different levels.
 3. Perhaps also assistance in the establishment of meter production facilities in Azerbaijan.
 4. Efficiency programs for both the energy and water sectors. Training courses for improvements of efficiency of use and also loss reduction programs.
 5. Improved tariff methodologies and general support to the new Tariff Commission.
 6. Assistance with the upcoming management contract and related issues in the gas sector.
 7. Promotion of alternative energy sources, such as wind power in Apsheron.
- There was further discussion, initiated by the minister, of possibilities for interconnecting energy networks with Armenia.
- The Minister inquired about the necessary next steps to facilitate USAID's participation in Azerbaijan. Emmrich noted that another mission may follow the current mission to more fully evaluate assistance needs.

Meeting Counterpart: Rafiq Aliyev, Special Advisor to the President of SOCAR

Date: 28 March, 2002

Attendees: H. Emmrich and E. Aladashvili, USAID/Caucasus; D. White, K. Owen, V. Vilayev, L. Mtchedlishvili, PA Consulting.

Discussion Summary:

- H. Emmrich opened the meeting by introducing the attendees and describing USAID's activities and approaches in the region and in Azerbaijan.
- Mr Aliyev noted that one of the most important areas for assistance would be in implementation of energy policy goal. He cited the recent 25 March decree as a positive step and credited the PA Consulting team with authoring several of its important provisions. However, he sees further focus on implementation, particularly in the area of collections' improvement, as necessary.
- There was discussion of USAID's work in the collections area. Dean White gave several examples of projects with positive results in both Georgia and Armenia. There was further discussion of debts and offset practices in other countries. Azerigas pays nothing to SOCAR. Recently, some offset arrangements have been successfully agreed among SOCAR, Azerenergy and Bages.
- Discussion of the new Tariff Committee revealed that SOCAR had not been informed of the Committee's existence.
- It would appear that SOCAR's relationship with the Ministry of Fuel and Energy is still in a state of development. Aliyev noted that perhaps 70-80% of the Ministry's employees have been drawn from SOCAR.
- SOCAR receives no reports on collection results by Azerenergy (or the distribution companies) or Azerigas.
- The meeting was very open, frank and friendly and future co-operation with and assistance by USAID was welcomed by Aliyev.

Attachment 3:

March 25, 2002, Presidential Decree on Energy Sector Reform

RESOLUTION OF THE PRESIDENT OF AZERBAIJAN REPUBLIC

On measures to strengthen financial discipline in the energy and water sectors

For the purpose of improving energy and water supply to the population and to the economy, as well as for strengthening financial discipline in those sectors, I decide that:

1. "Program on Strengthening of Financial Discipline in the Energy Sector" shall be adopted;
2. "Program on Strengthening of Financial Discipline in the Water Sector" shall be adopted;
3. The Cabinet of Ministers, jointly with relevant ministries and other state bodies, shall ensure that measures envisaged in those programs are implemented at full;
4. This Resolution shall become effective from the day it is published.

Heydar Aliyev
President of Azerbaijan Republic
Baku City, March 25, 2002
#893

Approved by the Presidential Resolution # 893

Dated March 25, 2002

PROGRAM

On Strengthening of Financial Discipline in the Energy

Sector

1. Essence of the problem

Expedient measures related with development of the energy sector have been taken during the latest years. Just during 2000-2001 the country's generation capacity has increased by 265.5 megawatt as a result of launching into operation of the Yenikend Hydro Power Plant, the Baku Thermal Power Central, and the steam generator at the Ethylene-Polyethylene Factory Electricity, as well as the reconstruction of Mingechaur Hydro Power Plant. Construction of 400 megawatt "Shimal" Hydro Power Plant and other new power plants, upgrading of existing equipment, as well as installation of transmission lines, and a number of projects in this field are currently underway. Implementation of the above-mentioned measures creates favorable grounds to fully meet the demand for energy by the population and enterprises.

At the same time there is a number of problems that impede the implementation of reforms in the energy sector. From this point of view, the prevention of mutual nonpayments in the energy sector and of the failure to fulfil budget commitments by enterprises arising as a result of such nonpayments became a primary task. The essence of the problem is that the joint-stock companies Azerenergy and Azerigas do not pay at full for the oil products and gas they receive from the State Oil Company, while the State Oil Company in its turn does not provide full payment of taxes to the state budget. As a result of this, a process of implicit subsidizing of Azerenergy and Azerigas from the state budget takes place.

Based on estimates, only in 2001 the State Oil Company supplied **manat 1.5 trillion** (\$315 **million**) worth of fuel to Azerenergy for generation of electricity. The value of this fuel at international prices makes up manat 1.9 trillion (\$ 396 million).

In 2001 the State Oil Company supplied **manat 273 billion** (\$57 **million**) worth of gas to Azerigas (apart from gas, which was envisaged for Azerenergy). The value of this gas at international prices is manat 897 billion (\$ 187 million).

In total, the State Oil Company supplied **manat 1.8 trillion (\$ 372 million)** worth of fuel to Azerenergy and Azerigas. If calculated at international prices this total amount will be manat 2.8 trillion (\$583 million).

However in 2001 the collection of electricity and gas fees from the population and enterprises was at very low level. The average level of collection for the entire country was 27% for electricity and 30% for gas. As a result, the difference is covered by implicit subsidies from the state budget. The money, which is collected for consumption of gas and electricity, is used only to pay salaries to employees and to cover operational expenses at Azerenergy, Azerigas, and enterprises dealing with sale of electricity and gas. Azerenergy and Azerigas almost fail to fulfill their obligations in respect to the state budget, the State Oil Company, and foreign credits. In 2001 the State Oil Company received the total of manat 7.5 billion from Azerenergy for supplied fuel (0.5% of the value of supplied fuel), and manat 3.5 billion from Azerigas for supplied gas (1.3% of the value of supplied gas). Such low level of payments significantly reduces the opportunities for larger financing of budgetary sector wages, as well as of education, health, and other sectors, including increase in pensions.

The solution of non-payments problem in such critical sector of economy must be broken into 2 stages:

Stage 1: implementation of measures to prevent creation of new debts. During the stage 1, payments to SOCAR are planned at 20% in 2002, 30% in 2003, 45% in 2004, 65 % in 2005, 80-100% in 2006. During this period, the unpaid amounts will be regulated through securities, which will ensure accurate record keeping of debt volumes and transparency of this process as a whole.

Stage 2: restructuring of the stock of debts once the accrual of new debts is stopped.

2. Description of measures to strengthen financial

discipline

2.1. Budgetary measures

2.1.1. Formalization of implicit subsidies, i.e. regulation of the process of payments by Azerenergy and Azerigas for the fuel received from the State Oil Company in the state budget;

At initial stage, once the demand for fuel and the maximum amount that can be paid in cash for this fuel by both companies is identified, the Ministry of Finance through agreement with the Ministry of Fuel and Energy will issue securities to Azerenergy and Azerigas for the remaining amount, and these companies will pay for the fuel to the State Oil Company mainly with money and partially with these securities. The payment order will be issued only for

the purpose of precise record keeping of mutual arrears, as well as of the commitments to the state budget. This practice will apply in parallel with reforms at utility companies and other measures related to strengthening of financial capacities, and will continue until 100% cash payments is ensured (by 2006).

2.1.2. Identification of precise limits in the state budget in respect to utility services consumption by budget-financed institutions, proper use of such budget allocations, i.e. strict supervision over the payment of utility service fees and disconnection of institutions that consume services in excess of the limit;

In this regard, the limits have been established in the 2002 draft state budget, and utility companies have been assigned to disconnect the institutions that violate the rules. The state budget will include reserve expenditures only for a number of enterprises. As a result of these actions the collection rate at Baku Electricity Distribution Network is expected to reach 50% in 2002.

2.1.3. Application of card system in utility payments;

Payment cards will be applied for all utility services, including subway fares, and this will ensure significant increase in collections and as a result in budget revenues.

In order to ensure proper use of utility compensations, such compensations will be provided through the payment cards. These cards may be used only for payment of utility service fees.

2.2. Measures to improve financial indicators of Azerenergy and Azerigas

2.2.1. Increase in collection:

- Unconditional disconnection of organizations that fail to pay for utility services; carrying out inventory of consumers for this purpose; and compulsory installation of meters;
- Application of similar measures to households;
- Ensure that utility fees are paid by the date shown in contracts. Provision of stronger administrative measures in the legislation in respect to evasion of payment for utility services, and implementation of public awareness activities;
- Improvement of collection rate by distribution networks up to 100% by the end of stage 1 (2006);

2.2.2. Increase of efficiency of electricity production:

- Reduction of fuel to be spent on production of electricity;

At present, approximately 410 grams of conditional fuel is used to produce 1 kWh of electricity, which is quite high. This is related with non-payment of fuel fees (i.e. lack of incentives to reduce consumption of fuel, which makes these enterprises feel unconcerned) from one side, as well as with creation of favorable grounds for application of unreasonable tariffs, technical losses and cases of abuse by using monopolistic positions from another side.

- Full switch of thermal power plants to gas, which is more efficient, both economically and environmentally;

- Implementation of measures aimed at reduction of technical losses;

- Restructuring of Azerenergy and Azerigas.

2.3. Restructuring and privatization (concession) of utility companies

2.3.1. Speeding up the process of privatization or concession of electricity and gas distribution networks;

For this purpose, it is envisioned that Electricity Distribution Networks of Sumgait, Ganja and Ali-Bayramli, as well as gas distribution networks, will be given for concession within 2002.

2.4. Measures to improve financial indicators of the State Oil Company (SOCAR)

2.4.1. Restructuring of the State Oil Company

2.4.2. Improving the settlement operations between the enterprises under the State Oil Company;

2.4.3. Privatizing the servicing and other enterprises, as well as the social facilities or transferring those to other institutions, with the purpose to reduce production costs;

2.4.4. Strengthening of control over implementation of procurement and sales operations in accordance with existing legislation;

2.4.5. Implementation of measures to increase collections from domestic fuel consumers. **2.5. Measures on price and tariff regulation**

2.5.1. Comprehensive analysis of utility tariffs;

Estimates show that even if consumers make full payments to Azerenergy and Azerigas, these companies still will not be able to make full payments on their

debts to the State Oil Company as well as on other obligations. Tariff Board has been established to identify optimal level of tariffs and to promptly regulate them.

2.5.2. In the medium-term, implementation of appropriate measures aimed at gradual reduction of the spread between the domestic and export prices of oil, oil products and natural gas.

2.6. Other organizational measures

2.6.1. Accurate record-keeping of imported/exported electricity and gas;

2.6.2. Improving of administrative structure at large taxpayers and state companies, privatization of subsidiary servicing units, increasing the profitability of enterprises, and taking full control over their procurement operations, with the purpose to reduce production costs of large taxpayers and state companies and to ensure timely payment of taxes. Ensuring that these operations are implemented in accordance with the legislation on tenders;

2.6.3. Implementation of restructuring measures at other large energy consuming industrial enterprises, improvement of management, creation of joint-stock companies on the basis of self-financed state enterprises, strengthening of supervision over the use of their financial resources, as well as over the fulfillment of their commitments to the budget;

2.6.4. Conducting of audit, with the purpose to identify mutual arrears between the State Oil Company, Azerenergy and Azerigas and other large taxpayers, as well as their budget arrears, and to carry out comprehensive analysis of other financial indicators;

2.6.5. Azerenergy and Azerigas to provide the Ministries of Economic Development, Finance, and Fuel and Energy with monthly reports regarding the structure of accounts receivable by groups of consumers, the fuel consumption, as well as the losses and financial indicators;

2.6.6. The Ministries of Finance, Fuel and Energy, and Taxes to supervise the cash flow at Azerenergy and Azerigas;

2.6.7. Construction of modern power plants that will generate electricity and lower costs. Construction of a new 400 megawatt unit at "Shimal" Hydro Power Plant, 2 modern power plants 400 megawatt each in Sumgait and Ali-Bayramli, as well as completion of the 300 megawatt Unit # 9 at Mingechaur Hydro Power Plant;

2.6.8. Implementation of investment projects that are connected with use of alternative sources of energy;

2.6.9. Annual preparation and approval of the fuel and energy balance of Azerbaijan Republic.

III. Action Plan

#	Action	Objective	Implementing agency	Timing
Budgetary measures				
1	Provide in the state budget the subsidies related with purchase of fuel for Azerenergy and Azerigas	Elimination of implicit subsidies, prevention of accrual of arrears	Ministry of Economic Development, Ministry of Finance, Ministry of Fuel and Energy	Starting from 2003
2	Identify limits on utility consumption for budget-financed organizations, and disconnection of organizations that use the services in excess of the limits	Ensure that budget organizations pay for utility services	Ministry of Economic Development, Ministry of Finance, Ministry of Fuel and Energy, utility companies	Starting from 2002
3	Application of a card system in payments for utility services	Prevent cases of abuse, and ensure full payments for utility services	Ministry of Economic Development, Finance Ministry, National Bank of Azerbaijan, commercial banks	Starting from 2003
4	Provision of compensations in the state budget to the citizens who are eligible for discounts on utility services	Prevent cases of abuse, and ensure full payments for utility services	Ministry of Economic Development, Ministry of Finance, Ministry of Labor and Social Protection	Starting from 2002
Improving of financial indicators at Azerenergy and Azerigas				
5	Implementation of measures to increase collections	Ensure that full payments are made	Utility companies	Regularly
6	Provision of stronger administrative measures in the legislation against the cases of evasion from payments	Ensure that full payments are made	Ministry of Justice	2002
7	Reduction of fuel consumption and technical losses and switch of thermal power plants to gas, with the purpose to increase efficiency of electricity production	Ensure economic efficiency of electricity production	Ministry of Fuel and Energy	Starting from 2002
8	Restructuring and privatization (concession) of utility companies	Increase the quality and economic efficiency of utility companies	Ministry of Economic Development	2001-2002
9	Restructuring of Azerenergy and Azerigas	Increase the efficiency of production	Cabinet of Ministers, Ministry of Fuel and Energy, Ministry of Economic Development	2002-2003

Improving of the structure of the State Oil Company				
10	Restructuring of the State Oil Company	Increase the operational efficiency of the State Oil Company	Cabinet of Ministers, Ministry of Fuel and Energy, Ministry of Economic Development	2002-2003
Other organizational measures				
11	Accurate record-keeping of imported/exported electricity and gas	Ensure the supervision over the use of electricity and gas	State Customs Committee, Ministry of Fuel and Energy	Starting from 2002
12	Restructuring of large electricity-consuming enterprises, improvement of management and implementation of other measures	Ensure that electricity is used in the saving regime	Ministry of Economic Development	Starting from 2002
13	Azerenergy and Azerigas to submit monthly reports regarding the structure of accounts receivable by consumer groups, the fuel consumption, as well as the losses and financial indicators.	Strengthen financial discipline at Azerenergy and Azerigas	Ministry of Economic Development, Ministry of Finance, Ministry of Fuel and Energy, Ministry of Taxes	Starting from 2002
14	Implementation of investment projects that are related with use of alternative sources of energy	Increase production of electricity	Ministry of Economic Development, Ministry of Fuel and Energy	Regularly
15	Improving of administrative structure at large taxpayers (SOCAR, Azerenergy, Azerigas, ARWC, State Railway, Caspian Shipping Company) and state companies, privatization of subsidiary servicing units, increasing the profitability of enterprises, and taking full control over their procurement operations, with the purpose to reduce production costs of large taxpayers and state companies and to ensure timely payment of taxes. Ensuring that these operations are implemented in accordance with the legislation on tenders.	Increase of consumption efficiency, fulfillment of commitments to the state budget	Ministry of Economic Development, Ministry of Fuel and Energy, Ministry of Finance, State Procurement Agency	2002-2003
16	Conducting of international-standard audit, with the purpose to identify mutual arrears between the State Oil Company, Azerenergy and Azerigas and other large taxpayers, as well as their budget arrears, and to carry out comprehensive analysis of other financial indicators.	Clarify the financial indicators and the amount of arrears, ensure transparency in these processes	Ministry of Economic Development, Ministry of Finance, Ministry of Fuel and Energy	Starting from 2002

17	Construction of new power plants and modernization of existing ones	Increase the production of electricity	Ministry of Economic Development, Ministry of Fuel and Energy	Regularly
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Attachment 4

Draft World Bank Terms Of Referemces

Republic of Azerbaijan
Institution Building and Technical Assistance Credit – II

**1. INSTITUTIONAL BUILDING OF STRATEGIC ENTERPRISES
IN THE ENERGY AND WATER SECTORS**

2. CONSULTANTS' TERMS OF REFERENCE

Background

The main objectives of the economic program of the Republic of Azerbaijan are to reduce poverty through financial stability and sustainable and balanced economic growth, improved public sector and utilities services, private sector development, and on that basis raising employment and real incomes, and developing a social safety net to protect the poorest. Accelerated structural reforms which are the main policy tools of the Government, are at the heart of this economic reform program. The proposed IBTA-II will support crucial components of the Government's structural reform program.

The Government's Structural Reform Program includes:

- *public sector reforms* to strengthen: (i) management of future energy revenues; (ii) policies and institutions for public expenditure management; and (iii) poverty monitoring, social services and safety nets, special initiatives for the refugees and IDPs, and mitigate the impact on workers of the Government's privatization program through a comprehensive labor redeployment scheme.
- *accelerating the development of the non-oil sector* through continuous diagnosis and improvement of the investment environment.
- *improving financial discipline and service delivery in utility sectors* by: (i) eliminating quasi-fiscal deficits; (ii) creating an effective regulatory system; and (iii) encouraging private participation. This key element of SAC-II would mitigate the health risks associated with unsafe water, as well as the social, productive and environmental consequences of unreliable electricity and gas supply.

This assignment is to support the reduction of the Quasi Fiscal Deficit in the energy and water sectors.

Objective

To strengthen the operations of the energy enterprises or parts thereof which would continue to remain in state ownership for the foreseeable future.

Scope of Work

The Consultant will:

1. Work with the Ministry of Economic Development (MED) to develop a list of energy enterprises to be subject of this assignment. The list will include Azerenergy, Azerigas, ARWC, and some others.
2. Make an assessment of the fiscal burden of each enterprise on the list. This would include quantifying issues including but not limited to: Direct infusion of subventions or subsidies from the budget, tax arrears, arrears to state owned input suppliers (including aging of receivables), subsidized credit (including debt forgiveness or rollovers), below market price of inputs from state owned enterprises, etc.
3. For each of these enterprises, conduct a diagnostic operational audit to determine the causes of the fiscal burden and how it can be eliminated. List the major causes of the problem and quantify these.
4. Prepare a fiscal recovery plan for each of the selected enterprises. These plans would address the causes identified above within the context of the broad restructuring areas including but not limited to the following:
 - Financial Restructuring (if needed): This work will primarily focus on strengthening of the balance sheet and identifying options for treatment of assets (including fixed assets) and liabilities. For example restructuring debt, settling or seeking relief from debts, debt to equity conversions, spinning off assets, etc.
 - Accounting and Controls: The work will take into account the work done so far in conducting a review of existing accounting controls and procedures as well as reporting, both managerial and financial (for ARWC and any subsidiaries and divisions), to upgrade these to international (IAS) standards as quickly as possible.
 - Operational Restructuring (if needed): This work would include the analyses of the losses of the enterprise in detail including financial as well as non technical losses and the identification and quantification of the major causes as mentioned above e.g., pricing, collections, (while taking into

account technical losses, heat rate, efficiency) etc. Identifying a schedule of solution options for the enterprise to reduce these losses.

- Corporate Restructuring (if needed): Corporate Restructuring will typically involve unbundling or integrating the assets and businesses of the enterprise in order to more clearly specify asset boundaries and identify candidates for divestiture. These divestitures might include non core operations of the enterprise including social assets if these are a burden
- Organizational Restructuring: This work will strive to find synergies and economies through consolidating functions and departments, outsourcing services etc. The objective would be to better align the personnel costs of the operations with international benchmarks adjusted for local circumstances. This work will also address the issue of the impact of the restructuring on employees and find ways to ensure compliance with Government policy with regard to pensions social security and other universal rights and entitlements of the employees. In addition, the team will also work to resolve enterprise specific issues such as redundancy, severance, retraining, re-assignment, outplacement etc. In this regard the consultant will look to utilizing social programs currently in place. Creating new programs is beyond the scope of this assignment.

During the preparation of the diagnostic study as well as during the preparation of the restructuring plan, closely involve the staff and management of the enterprises so that they can learn the methods being employed by the consultant.

5. Based on the above restructuring work prepare a detailed action plan for the company to follow indicating specific action measures to be taken, dates and payoffs to be generated. These measures should be feasible and realistic given the economic and political environment and capital constraints, but can assume a continuing emphasis on reforms by the Government.
6. Review the plans with enterprise management to obtain consensus as to feasibility and conduct the required due diligence to verify the concerns of management. Modify the plans accordingly if justified.
7. Assist the MED to negotiate the restructuring measures with enterprise management and to obtain commitment.
8. Work with management and staff of the enterprises to implement the plan. In the process educate, train and develop the staff and management of the enterprises in best practices in the operational and financial management of these enterprises.

9. Assist the MED to monitor the progress against the agreed milestones.

Duration

The assignment will last over a period of one and a half years and require approximately 30 person months of effort with several trips to the country at key points of the process.

Team

International experience in the design and management of restructuring programs for energy and water enterprises, economic restructuring. Prior experience in restructuring, labor redeployment in centrally planned transition economies. Familiarity with World Bank financed restructuring, labor and social support projects.

Reporting

The Team will report to the Ministry of Economic Development and work closely with the counterpart team nominated by the Ministry. A work plan will be prepared and submitted within 2 weeks of the commencement of the assignment, an interim report after six, nine and twelve months and a final report at the completion of the implementation work. The Government and the World bank will provide comments on these reports. The reports will also include presentations to the Counterpart team and if so recommended by the Counterpart team to the Ministry

3. IMPLEMENTING THE REGULATORY FRAMEWORK

4. CONSULTANTS' TERMS OF REFERENCE

Background

The main objectives of the economic program of the Republic of Azerbaijan are to reduce poverty through financial stability and sustainable and balanced economic growth, improved public sector and utilities services, private sector development, and on that basis raising employment and real incomes, and developing a social safety net to protect the poorest. Accelerated structural reforms which are the main policy tools of the Government, are at the heart of this economic reform program. The proposed IBTA-II will support crucial components of the Government's structural reform program.

The Government's Structural Reform Program includes:

- *public sector reforms* to strengthen: (i) management of future energy revenues; (ii) policies and institutions for public expenditure management; and (iii) poverty monitoring, social services and safety nets, special initiatives for the refugees and IDPs, and mitigate the impact on workers of the Government's privatization program through a comprehensive labor redeployment scheme.
- *accelerating the development of the non-oil sector* through continuous diagnosis and improvement of the investment environment.
- *improving financial discipline and service delivery in utility sectors* by: (i) eliminating quasi-fiscal deficits; (ii) creating an effective regulatory system; and (iii) encouraging private participation. This key element of SAC-II would mitigate the health risks associated with unsafe water, as well as the social, productive and environmental consequences of unreliable electricity and gas supply.

This assignment is a follow up on prior work that has been done in designing the Regulatory Framework. This assignment implements that regulatory framework.

Objective

To strengthen capacity in the agency or agencies (hereafter called the Responsible Authority) with responsibility for economic regulation of the network infrastructure sectors (electricity, natural gas, and water).

Scope of Work

Specific responsibilities of the consultants will include the following tasks:

1. Confirmation of GOA objectives for infrastructure as a whole and for each of the network infrastructure sub-sectors (electricity, natural gas and water), and confirmation of the GOA policies that have been developed to achieve those objectives
2. Confirmation of GOA objectives for infrastructure economic regulation consistent with sector policy, and understanding of current and future intentions with regard to network infrastructure privatization
3. Diagnostic of the current state of regulatory capacity, including mapping of responsibilities (especially identification of current allocation of responsibilities for pricing, quality, entry/exit, competition, monitoring, enforcement, dispute resolution, appeals, and judicial review); current staffing and funding mechanisms.
4. Analysis of current procedures -- the Consultant should use flowchart software (such as Visio or a similar package) to model key regulatory procedures as they exist today. The Consultant should evaluate current procedures for their consistency with GOA objectives and policy, for administrative effectiveness and budget efficiency, and for transparency and clarity.
5. Human resources evaluation -- the Consultant should make an assessment of current staff and officials responsible for infrastructure regulation and identify any critical gaps in skills necessary for current functions
6. On the basis of 1-4, the Consultant should make recommendations concerning: the allocation of regulatory responsibilities; regulatory procedures; and the staff mix (including drafting of a new organization matrix and job descriptions. New procedures should be developed as flow charts and only when accepted by GOA should procedures be written (and then regulatory staff should take the lead role in the drafting, i.e. the eventual users should be actively involved in writing the procedures manual)
7. The Consultant should prepare a draft budget and identify funding options for the Responsible Authority, including options for license/concession fees
8. On the basis of agreement with GOA on 6 and 7, the Consultant

should prepare a detailed capacity strengthening plan to build the technical and administrative skill of the agency. Specific components of the plan, should indicate both the type of activity such as a training course, and the functional areas such as marginal cost ratemaking.

9. Assist the Responsible Authority to implement the capacity strengthening plan.

Duration

The assignment will last over a period of one and a half years and require approximately 80 person months of effort with several trips to the country at key points of the process.

Team

The team to be fielded by the consultant will need to include technical, regulatory and tariff experts in each of the sectors to be included. Experience in setting up regulatory regimes in transition economies will also be of value.

Reporting

The consultants, under this assignment will report to the Responsible Authority, the Ministry of Economic Development and specifically to the counterpart for this assignment as designated by the Ministry.

The consultant will deliver a project plan within two weeks of commencement of the assignment. An interim draft report covering phase one and all the major areas in the scope of work will be submitted within four months of commencement for review and discussion by the Government. Based on the feed back form the Government and further work on part of the consultant, a final report for phase one will be due at the end of six months from commencement.

5. BUILD WORKOUT CAPACITY TO DEAL WITH DELINQUENT ENTERPRISES

6. CONSULTANTS' TERMS OF REFERENCE

Background

The main objectives of the economic program of the Republic of Azerbaijan are to reduce poverty through financial stability and sustainable and balanced economic growth, improved public sector and utilities services, private sector development, and on that basis raising employment and real incomes, and developing a social safety net to protect the poorest. Accelerated structural reforms which are the main policy tools of the Government, are at the heart of this economic reform program. The proposed IBTA-II will support crucial components of the Government's structural reform program.

The Government's Structural Reform Program includes:

- *public sector reforms* to strengthen: (i) management of future energy revenues; (ii) policies and institutions for public expenditure management; and (iii) poverty monitoring, social services and safety nets, special initiatives for the refugees and IDPs, and mitigate the impact on workers of the Government's privatization program through a comprehensive labor redeployment scheme.
- *accelerating the development of the non-oil sector* through continuous diagnosis and improvement of the investment environment.
- *improving financial discipline and service delivery in utility sectors* by: (i) eliminating quasi-fiscal deficits; (ii) creating an effective regulatory system; and (iii) encouraging private participation. This key element of SAC-II would mitigate the health risks associated with unsafe water, as well as the social, productive and environmental consequences of unreliable electricity and gas supply.

This assignment is to support the reduction of the Quasi Fiscal Deficit in the energy sector.

Enterprises which are willing but unable to pay their utility bills in full but wish to be granted relief from collection action such as being shut off, will, under this program if so allowed,

apply to the MED for support in restructuring their operations so as to, within one year, be able pay their bills fully on a regular basis.

Objective

To build capability within the Ministry of Economic Development (MED) to prepare and put in place workout plans that large enterprises can meet, as a condition for relief from collection action, if they are willing but unable to pay their utility bills in full.

Scope of Work

The Program

The Consultant will:

10. Work with the Ministry of Economic Development (MED) to develop a workout program and process for enterprises seeking relief from immediate collection action as described above. The broad parameters of the program will include but not be limited to:
 - Developing criteria for eligibility for inclusion in this program. The criteria, inter alia, will include the reasonable likelihood of the enterprise being able to meet its obligations as a going concern within one year.
 - Designing the application and approval process for entry into the program.
 - Setting standards for performing the diagnostic operational audits of the enterprises and preparing a standard work plan, timetable for completion and reporting formats for these audits.
 - A detailed workout plan (Enterprise Recovery Plan) with clearly defined action measures for the company to implement, with dates and payoffs to be generated. These measures should be feasible and realistic given the economic and political environment and capital constraints, but assuming a continuing emphasis on reforms by the Government.
 - The Enterprise Recovery Plan should have standardized formats and benchmarks for the workout. The standardized plan and the milestones, should allow objective comparison between enterprise performance during the workouts so that the fairness and objectivity of the process is maintained and demonstrated.

- A standardized procedure and protocol for monitoring the progress against benchmarks and pre-determined penalties for slippage including premature exit from the program.
- Exit from the program will be, no later than one year from the date on which the enterprise agrees to the workout plan or sooner if the workout plan so stipulates or if there is no agreement within one month of the enterprise receiving the workout plan.
- The arrears accumulated during the workout period will have to be settled over time as determined by the workout plan.

Labor Issues

- This workout program will also address the issue of the impact of the workout on employees and find ways to ensure compliance with Government policy with regard to pensions, social security and other universal rights and entitlements of the employees. In addition, the program will also work to resolve enterprise specific issues such as redundancy, severance, retraining, re-assignment, outplacement etc. In this regard the workout team will utilize social programs currently in place but creating new programs is beyond the scope of this assignment.

Accounting Issues

- The workout program will also include the review of accounting controls and procedures as well as reporting, both managerial and financial, to upgrade these to international (IAS) standards with the milestones for this extending beyond the workout period if so stipulated by the workout plan but with the provision that the accumulated dues during the workout period would be accelerated if the milestones under the accounting reform program were not met.

Capacity Building

The consultant will:

3. Assist the MED by working closely with the counterpart team to help set the criteria for selection, search, locate and recruit the appropriate technical, financial and management human resource skills needed to staff the workout team at the MED.
4. Assist the Government by working closely with the counterpart team to educate and train the workout staff so that they can develop the capability to work in a quick response “SWAT” team mode to quickly go into an enterprise and through a short but intense assignment develop an actionable workout plan.

5. Design, procure, install and render operational, the required information technology systems, including hardware and software, that the workout team would require in order to function effectively and efficiently.

Demonstrative Workouts

6. Conduct demonstrative diagnostic operational audits and develop the workout plans to illustrate how the procedures are to be implemented. Specifically conduct demonstrative audits of at least 5 enterprises. The consultant will then participate in one after every five workouts for another five workouts. (This ongoing work to be separately funded.)

Duration

The assignment will last over a period of one and a half years and require approximately 40 person months of effort with several trips to the country at key points of the process.

Team

International experience in the design and management of turnaround and workout programs for industrial and infrastructure enterprises. Prior experience in restructuring, labor redeployment in centrally planned transition economies. Familiarity with World Bank financed restructuring, labor and social support projects.

Reporting

The Team will report to the Ministry of Economic Development and work closely with the counterpart team nominated by the Ministry. A work plan will be prepared and submitted within 2 weeks of the commencement of the assignment, an interim report after six, nine and twelve months and a final report at the completion of the implementation work. The reports will also include presentations to the Counterpart team and if so recommended by the Counterpart team to the Ministry

**Azerbaijan Republic
Baku Gas Distribution Company
Privatization Project**

**Financial Advisory Services
Terms of Reference**

Background

The Government of the Republic of Azerbaijan has approved a strategy for the privatization of natural gas distribution in Azerbaijan. The strategy calls for fast-track privatization of a gas distribution utility enterprise with a service territory that includes, at a minimum, the metropolitan area of Baku. Possible inclusion of a wider territory in this service territory is the subject of on-going natural gas sector strategy work, which will also define a privatization strategy for any parts of gas distribution not included in the initial transaction.

Based on these directives of the Government, the Ministry of Economic Development (MED), through its Privatization Agency (PA), has established a Transaction Team (TT) to implement the necessary steps for the privatization of the gas distribution utility. The TT will develop, manage, and follow up the activities of the privatization project throughout its implementation. The TT will report to the PA for review and approval of all matters prior to presentation to the MED.

The TT will nominate qualified consultants in finance, gas distribution utility operations, and legal affairs from a list of approved candidates. The selected consultants will advise the privatization unit of the Ministry of Economic Development on matters regarding the implementation of privatization. The recruitment of these consultants will proceed in tandem. However, there will be only one contract for the Financial Advisor and gas distribution utility consultant with the gas distribution utility consultant being a subcontractor to the Financial Advisor. The Financial Advisor will select, negotiate and conclude the sub contract with the gas distribution utility Consultant. The Financial Advisor will include the details about the gas distribution utility Consultant and the terms and conditions of the sub-contract as part of the Financial Advisor's bid. The Legal Advisor will be retained under a separate contract. The three together will form the Advisory Team (AT).

The terms of reference for the Financial Advisor and the overall AT assignment is set forth herein.

Objective

Assist the Government of Azerbaijan with preparation and implementation of a privatization plan for the gas distribution utility, by first assisting in completing the financial and corporate restructuring of the gas distribution utility and then in completing the privatization. Inputs to the process on overall strategic objectives for the gas sector, and the policy and regulatory choices that will be made in order to pursue those objectives, will come from the natural gas sector strategy exercise now underway.

Scope of Work

The work program under these terms of reference will be conducted in two phases. The First Phase will be the preparatory work for the privatization transaction and the Second Phase will be the Tendering Process. However, under Azerbaijan laws on procurement and tendering, Phase II can begin only after relevant state decrees have been issued on establishing the Gas Distribution Company and its privatization, and as such it will be contracted separately only upon such decree being issued. However, for the sake of continuity and economy, it is desirable and necessary that the advisor selected for Phase I be the same one who performs the work under phase II, even though phase II will be contracted separately. Since the compensation for phase II will be only on a success fee basis, the advisor for phase I will have to indicate in its bid for Phase I, its requirement for the success fee as a percentage of the transaction value in Phase II in the event that there is in fact a Phase II and should the advisor be contracted to perform the work under phase II. However, there is no assurance that there will be a phase II, and in the event that there is no phase II the compensation under phase I will be the only compensation the consultant will be entitled to

The AT will coordinate closely with the consultants (NERA, with Penspen, AUPEC, and Baker & McKenzie, hereafter referred to as the “Strategy Consultant”) which are assisting GOA with the natural gas sector strategy (this work is being grant funded by ESMAP and PPIAF). These consultants are developing a strategy for the energy sector, encompassing the development of a coordinated policy for the structure of the market, restructuring of Azerigaz, the regulatory framework, and the social protection approach, and preparation of a sector financial mode. The AT will obtain from and use the results of the work of these consultants and not duplicate any of their work. The following description of the scope of work for the AT is written on this assumption. A copy of the terms of reference of for the natural gas sector strategy work have been provided in the RFP package for the convenience of the Bidders.

In conjunction with the Legal Advisor (the Legal Advisor will only be contracted when the Second Phase is approved by Government), where needed, in each of these phases, the AT will:

PHASE I

1. Within four weeks of the commencement of the assignment, prepare a detailed work plan for the implementation of the privatization project. This plan would include a description of all the activities and events, deliverables by each party concerned, and a timetable for each activity and deliverable. This plan would include but not be limited to the list of actions described in the scopes of work of all advisors engaged for the project.
2. Coordinate with the Strategy Consultant. Key policy decisions concerning market structure, re-organization of Azerigaz, regulatory requirements, and social protection should follow soon after the submission of the Strategy Consultant’s “Options” report in April 2002. This will identify the preferred option for packaging distribution assets to be offered for private sector participation. It will also identify critical changes to primary legislation (if any), the governance documents necessary to support the transactions (licenses et.al.), the regulatory requirements, and the trading relationships of the distribution sector to the other operating entities in the gas sector. The gas distribution AT should re-confirm all

policy decisions that have been made and should ensure a thorough understanding of the work of the Strategy Consultant.

3. Based on these inputs, the AT should begin preparation of the gas distribution entity for privatization. This would include but not be limited to:
 - Undertaking all planning and implementation steps for the unbundling of the gas distribution entity from Azerigaz, including personnel allocation, development of pro forma balance sheets, identification of critical operational factors (including bulk metering), assessment of information systems related especially to financial management, and other steps as necessary.
 - As a core part of the financial work, advise MED on the optimal capital structure for the gas distribution company including the requirement for debt restructuring and revaluation of assets.
 - As a core part of the financial work and using the sector financial model developed by the Strategy Consultant as an essential input, development a financial model for the gas distribution entity identifying capital investment requirements and the required tariff path.
 - Preparation of the Data Room and other steps to support the investor due diligence process.
 - Preparation of the privatization marketing strategy and campaign indicating target investors, as well as development of the bidding process (including bidding and evaluation criteria). The marketing strategy should include formal mechanisms to ensure that private sector views of opportunities and risks in the proposed package can be considered (a Road Show should be at least a part of this mechanism). The advice should also include recommendations as to the key variable(s) on which private investors should bid (options to be considered include but are not limited to share price, tariffs, investment commitment, and minimum subsidy).
 - The AT should also provide advice to the MED on retrenchment strategy, including ensuring compliance with Government policy with regard to pensions social security and other universal rights and entitlements of the employees.
 - The AT will advise on public relations strategy, but will not be primarily responsible for this aspects.
4. Based on the above, the AT and the TT will submit a Privatization Plan to the PA and the MED specifying a time-bound plan leading to financial close for the gas distribution transaction. The Privatization Plan should be accompanied by the draft RFP which is substantially complete other than for specification of selected financial and operational details that require GOA decisions, but should otherwise include the drafts of the Info Memo, license or other appropriate governance document, and draft bidding instructions, as well as all bidding schedules.

5. This Plan and Draft RFP with PA's recommendations will be submitted to the MED and to higher levels, if so required, for clearance to go to the next stage.

PHASE II

6. Upon approval of the privatization plan, the AT will prepare pre-qualification criteria for the prospective bidders and based on this, the AT will prepare a "Long List" of potential bidders who would be invited to submit expressions of interest including pre-qualification data and then screen the expressions of interest according to the pre-qualification criteria to prepare a short list to whom the RFP would be sent..
7. The AT will then help the TT conduct the Tendering Process. The process will be implemented in collaboration and cooperation with the other relevant Government organizations and will include but not be limited to the following steps:
 - The TT in coordination with the sector organization and the enterprise, if any, will form a Tendering Committee (TC) consisting of six (6) members as follows: PA-1, Sector Ministry - 1, the gas distribution utility - 1, Audit Department of the Ministry of Finance - 1 and the Legal Department of the Ministry of Finance -1, and one representative from civil society with knowledge of the sector. The TC will be chaired by the PA.
 - The AT will assist in finalization of the RFP with the help of the TT and the Sector resources based on the data developed in the previous stages. Finalization of the RFP will include:
 - i. Completion of a final information memorandum describing the privatization opportunity and the objectives of the government,
 - ii. Completion of all the relevant and necessary contracts and agreements in proforma draft form, so that the terms and conditions of the transaction, and under which the bids are invited, are clearly spelled out.
 - iii. Determination of all fixed financial and operational parameters, so that the bids can be compared on the basis of one or at most two variables.
8. Following this the AT will help the TT to:
 - i. Invite the short list to pre-bid meetings and schedule the due diligence period, including the timeframe in which the data room will be open.
 - ii. Send out the RFP to at least three potential bidders.(Part of AT's success fee may depend on the number of bids obtained)

- iii. Open and evaluate the bids according to the protocol and criteria set forth in the RFP. The scoring will be done by the TC for the technical proposal and the average score of the TC will be used to decide the "pass-fail".
- iv. Select the winner based on the financial bids of the technical bids that "pass".
- v. Invite the winner for negotiations to finalize the contracts and other agreements.
- vi. Help the TT to present the Winner to the MED and to any higher authority as required, for approval to sign the contracts and other agreements.

The Team

The AT will provide an appropriate team from its staff to work on this assignment. The expertise should include experience in operations, privatization, financing, restructuring and concessions, leases and management contracts etc for gas distribution utilities. The AT should have a dedicated team present in Azerbaijan during critical periods of the privatization, e.g., during evaluation of bids or offers, negotiations etc. Experience in the Central Asia and the Caucasuses and in particular Azerbaijan would also be helpful.

Duration and Level of Effort

It is expected that the entire assignment will be over a period of 18 to 24 months during which the privatization will have to be completed. The AT is expected to allocate appropriate human resources to achieve the privatization goals within this time period.

Reporting Arrangements

The TT will be the primary and sole liaison between the consultant teams and other levels of the Organization and the Government. The AT will work hand in hand with the TT throughout all phases of the project and the TT will have the primary oversight authority during the implementation of the project. The deliverables will be as specified in the work plan to be developed as in Paragraph #1 above.

**Azerbaijan Republic
Baku gas distribution Company
Privatization Project**

**Gas Distribution Utility Consultancy Services
Suggested Terms of Reference**

Background

The Government of the Republic of Azerbaijan has approved a strategy for the privatization of gas distribution utilities in Azerbaijan. The strategy that was approved calls for the privatization of the gas distribution utility enterprise in the metropolitan area of Baku.

Based on these directives of the Government, the Ministry of Economic Development (MED), through its Privatization Agency (PA), has established a Transaction Team (TT) to implement the necessary steps for the privatization of the gas distribution utility. The TT will develop, manage, and follow up the activities of the privatization project throughout its implementation. The TT will report to the PA for review and approval of all matters prior to presentation to the MED.

The TT will nominate qualified consultants in Finance, gas distribution utility, and Legal Affairs from a list of approved candidates. The selected consultants will advise the gas distribution utility on matters regarding the implementation of privatization. The recruitment of these consultants will proceed in tandem. However, there will be only one contract for the Financial Advisor and gas distribution utility Consultant with the gas distribution utility Consultant being a subcontractor to the Financial Advisor. The Legal Advisor will be retained under a separate contract. The three together will form the Advisory Team (AT).

The terms of reference for the gas distribution utility Consultant assignment is set forth herein.

Objective

Support the Financial Advisor with necessary and sufficient technical, industry and operating input in preparing and implementing a privatization plan for the gas distribution entity.

Scope of Work

The work program under these terms of reference will be conducted in two phases. The First Phase will be the preparatory work for the privatization transaction and the Second Phase will be the Tendering Process. However, under Azerbaijan laws on procurement and tendering, Phase II can begin only after relevant state decrees have been issued on establishing the Gas Distribution Company and its privatization, and as such it will be contracted separately only upon

such decree being issued. However, for the sake of continuity and economy, it is desirable and necessary that the advisor selected for Phase I be the same one who performs the work under phase II, even though phase II will be contracted separately. Since the compensation for phase II will be separate for the technical consultant, the Financial Advisor will have to indicate in its bid for Phase I, its requirement for the technical consulting fee in Phase II in the event that there is in fact a Phase II and should the advisor be contracted to perform the work under phase II. However, there is no assurance that there will be a phase II, and in the event that there is no phase II the compensation under phase I will be the only compensation the consultant will be entitled to

The gas distribution utility consultant will operate under the direction of the Financial Advisor, and like the FA will coordinate closely with the Strategy Consultant (and work according to the approved Strategy of GOA in the gas sector once approved). In conjunction with the Financial Advisor and the Legal Advisor where needed, for each of these phases, the gas distribution utility Consultant will:

PHASE I

1. Provide technical and industry input to assist the Financial Advisor to prepare a detailed work plan for the implementation for the privatization project. (This plan would include a description of all the activities and events, deliverables by each party concerned, and a timetable for each activity and deliverable. This plan would include but not be limited to the list of actions described in the scopes of work of all advisors engaged for the project). Specifically, the gas distribution utility consultant will identify all the technical and industry related milestones for the plan, estimate the time required for their completion and recommend assignment of responsibility for their delivery.
2. Be responsible for gathering the necessary technical, company and industry data and performing the necessary analyses to examine the current situation in the gas distribution entity.
3. Work with the Financial Advisor to develop recommendations for various options available for implementing the privatization, based on this data gathering and analyses. This would include but not be limited to:
 - Technical and industry input for evaluating operating parameters of the gas distribution utility in order to develop strategies and options for its privatization.
 - Identify environmental issues, if any, that might arise as a result of the privatization transaction and recommend how these issues should be addressed. This work will include a review of the base line conditions, potential direct or indirect impact, preventive or mitigatory or compensatory measures, training and monitoring processes.

- Technical and industry input for preparing a privatization marketing strategy based on the restructured enterprise indicating industry experience as to target investors and deal structures.
4. Assist the Financial Advisor in developing a corporate restructuring plan to address the treatment of assets of the gas distribution utility and specify the asset boundaries.
 5. Prepare a comprehensive plan to address all staff and human resource issues pertaining to the restructuring and privatization. Upon approval of this human resource deployment plan, assist the TT in implementing the plan. The plan would include but not be limited to:
 - Treatment of employment security and employee status
 - Treatment of pension and other social security issues
 - Placement and training assistance where needed

PHASE II

6. Assist the Financial Advisor in preparing the technical portions of the RFP documents for implementing the privatization. (the gas distribution utility will arrange at its own expense to provide audited financial statements for the gas distribution utility) The gas distribution utility consultant will be responsible for ensuring that all the technical and market information needed for these documents is available to the Financial Advisor and will ensure the quality of the technical and market information contained in these documents. The gas distribution utility consultant will also provide support to the TT and the Financial Advisor to set up the data room.
7. Assist the TT and the Financial Advisor in evaluating the technical aspects of any proposals or bids received.
8. Assist the TT, the Financial Advisor and the potential partners and investors with final due diligence activities.

The Team

The gas distribution utility consultant will provide an appropriate team from its staff to work on this assignment. The expertise should include experience in gas distribution utility network design, operations, restructuring and privatization. The gas distribution utility Consultant should have a dedicated team present in Azerbaijan during critical periods of the privatization, e.g., during data gathering for the preparation of the privatization plan and offering documents, evaluation of bids or offers, final due diligence etc. Experience in the FSU and in particular Azerbaijan would also be helpful.

Duration and Level of Effort

It is expected that the assignment will be over a period of 18 to 24 months during which the privatization will have to be completed. The gas distribution utility consultant is expected to allocate appropriate manpower resources to achieve the privatization goals within this time period. It is envisaged that the gas distribution utility consultant will have to provide at least ____ person-months of effort to complete this assignment.

Reporting Arrangements

The TT will be the primary and sole liaison between the consultant teams and other levels of the Organization and the Government. The gas distribution utility consultant will report to the Financial Advisor in this assignment but will work hand in hand with the TT throughout all phases of the project and the TT will have the primary oversight authority during the implementation of the project. The deliverables will be as set forth in the overall implementation plan prepared at the outset of the assignment as indicated in paragraph #1 above.

**Azerbaijan Republic
Baku gas distribution Company
Privatization Project**

7. LEGAL ADVISORY SERVICES

Suggested Terms of Reference

Background

The Government of the Republic of Azerbaijan has approved a strategy for the privatization of gas distribution utility in Azerbaijan. The strategy that was approved calls for the privatization of the gas distribution utility enterprise in the metropolitan area of Baku.

Based on these directives of the Government, the Ministry of Economic Development (MED), through its Privatization Agency (PA), has established a Transaction Team (TT) to implement the necessary steps for the privatization of the gas distribution utility. The TT will develop, manage, and follow up the activities of the privatization project throughout its implementation. The TT will report to the PA for review and approval of all matters prior to presentation to the MED.

The TT will nominate qualified consultants in Finance, gas distribution utility, and Legal Affairs from a list of approved candidates. The selected consultants will advise the gas distribution utility on matters regarding the implementation of privatization. The recruitment of these consultants will proceed in tandem. However, there will be only one contract for the Financial Advisor and gas distribution utility Consultant with the gas distribution utility Consultant being a subcontractor to the Financial Advisor. The Legal Advisor will be retained under a separate contract. The three together will form the Advisory Team (AT).

The terms of reference for the Legal Advisor assignment is set forth herein.

Objective

Provide the necessary and sufficient Legal Advisory support, including representation as counsel, for the preparation and implementation of the privatization plan by first providing Legal Advisory support in completing the financial and corporate restructuring of the gas distribution utility and then in completing the privatization.

Scope of Work

The work program under these terms of reference will be conducted in two phases. The First Phase will be the preparatory work for the privatization transaction and the Second Phase will be the Tendering Process. The Legal Advisor would need to

commence activities in advance of the start of Phase II but after the approval of Phase II by the Government.

In conjunction with the Financial Advisor and the gas distribution utility consultant, for each of these phases, the Legal Advisor³ will:

PREPARATION FOR PHASE II

1. Contribute to the preparation of a detailed work plan for the implementation of the privatization project. Specifically, the Legal Advisor will identify milestones pertaining to legal and regulatory issues and documentation, estimate the time required for attaining these and recommend assignment of responsibility for related deliverables.
2. Review the data and analyses prepared by the Strategy Consultant to examine the current legal and regulatory situation in the gas distribution utility as well as issues pertaining to concessions, leases management contracts etc.
3. Based on this data and analyses, contribute to the development of the policy options related to the privatization. This contribution would include but not be limited to:
 - Review of the proposed legal and regulatory framework as to its ability to support private sector participation in gas distribution utility in the country.
 - Review of the proposed sector policy options in terms of length of concession, exclusivity, universal service, tariffs etc.
4. Review the legal aspects of, and contribute to the financial and corporate restructuring plan to address the debt of the gas distribution utility, if any, and the treatment of core and non-core assets of the gas distribution utility.
5. Upon approval of the financial and corporate restructuring plan (in par. #4 above), assist the TT in taking the necessary steps for implementing these plans. This would include preparing the articles of incorporation for the restructured entities if any, preparing documentation related to title, asset boundaries etc., preparing and filing the necessary corporatization documents and preparing the agreements needed for the financial restructuring of the gas distribution utility including contracts for divestiture of assets or equity participation, draft concession documents etc.
6. Review and provide guidance on the legal constraints and options in the plan to be prepared by the gas distribution utility Consultant to address staff and human

³ Although the legal advisor will initially perform in the capacity of a legal consultant, he will in fact also represent the Government and/or the gas distribution utility as counsel in these transactions.

resource issues pertaining to the restructuring and privatization. This would include addressing the legal aspects of:

- Treatment of employment security and employee status
 - Treatment of pension and other social security issues
7. Assist in the preparation of an information memorandum (IM) or other offering document for implementing the privatization. In particular provide the section on the legal and regulatory framework and policy.

PHASE II

8. Participate and assist in the negotiations with winning bidders or otherwise selected partners upon government approval.
9. Prepare, and assist in the negotiations related to, any and all ancillary documents pertaining to the transactions.
10. Assist the TT and the potential partners and investors with final due diligence activities.
11. Assist the TT and the Government in reaching a closing with the parties involved in negotiations.

The Team

The Legal Advisor will provide an appropriate team from its staff to work on this assignment. The expertise should include experience in gas distribution utility privatization, financing, restructuring and concessions, leases, management contracts etc. The Legal Advisor should have a dedicated team present in Azerbaijan during critical periods of the privatization, e.g., during evaluation of bids or offers related to transactions, negotiations etc. Experience in the FSU and in particular Azerbaijan would also be helpful. The firm will also have to have on its team attorneys with knowledge and experience in the Azeri legal system.

Duration and Level of Effort

It is expected that the assignment will be over a period of 18 to 24 months during which the privatization will have to be completed. The Legal Advisor is expected to allocate appropriate manpower resources to achieve the privatization goals within this time period. At least ___ person months of effort will have to be provided.

Reporting Arrangements

The TT will be the primary and sole liaison between the consultant teams and other levels of the Organization and the Government. The Legal Advisor will work hand in hand with the TT throughout all phases of the project and the TT will have the primary oversight authority during the implementation of the project. The deliverables

will be in accordance with the overall implementation and schedule developed at the outset of the assignment as per paragraph # 1 above.